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INPUT® Research Bulletin

Route to:

A Publication from INPUT's U.S. Information Services Market Analysis Program

The Bell Atlantic/TCI Merger
The New Telecommunications Paradigm?

Reading the Tea Leaves

INPUT's 1993 annual analysis and five-year forecast of the U.S. Telecommunications market for information services identified the convergence of communications industries, such as common carrier and cable television, as key business trends that will have far-reaching effects on this marketplace.

Examples included purchased interests or acquisitions by many of the regional Bell holding companies (RBOCs). These included planned or completed transactions between Southwestern Bell and Hauser Communications, U S West and Time/Warner, Nynex and Viacom, and BellSouth and Prime Management Co.

The INPUT report stated that "major common carriers and cable television organizations are in the process of either merging or forming new alliances. The brass ring that everyone is now reaching for is broadband interactive television services, including voice, data and multimedia. This is facilitated through a convergence of computing, communications and entertainment [resources]. The focus now seems to favor consumer services over business services."

INPUT noted that the Clinton administration's objective of constructing a nationwide broadband network that would include a 500-channel cable TV capability—the new *electronic superhighway*—will provide a strong impetus for change in the telecommunications industry. Various potential acquisitions and alliances between communications companies were considered—but not a merger between Bell Atlantic and TeleCommunications, Inc.—the largest and richest of the cable-TV operators. When the telecommunications industry speculated about potential partners for TCI, AT&T was the company most frequently mentioned. The negotiations were well concealed until the October 13 announcement of the planned merger—a significant feat in an industry where information leaks are commonplace. And when the announcement was made, the specifics surprised the industry—not so much for the *what* of the deal, but for the *who* and the *how much*.

The Bell Atlantic/TCI Merger

The deal appears quite simple. Bell Atlantic will acquire the assets of TCI and Liberty Media Corporation (TCI's cable-programming sibling) for Bell Atlantic stock valued at about

$12 billion. In addition, Bell Atlantic will assume Liberty's $9-10 billion debt, bringing the total cost of the merger to more than $21 billion, and making it one of the largest in American corporate history.

Other telecommunications deals have been in the multi-billion dollar range, but none were, or are likely to be any larger than Bell Atlantic-TCI—that is, if it is allowed by the courts, the FCC and Congress to go to completion.

Organizationally, Bell Atlantic Chairman Raymond W. Smith, will continue in that role, while John C. Malone, CEO of TCI, will become Vice-Chairman of Bell Atlantic. Mr. Malone, who has earned the nickname *Darth Vader* for his strong management style, will become a billionaire as a result of the merger, but he will no longer be running TCI and Liberty and they will carry Bell Atlantic's identity. Malone, an electrical engineer, has stated that he has become tired of managing a large company and welcomes the fact that he will not have any executive responsibilities at Bell Atlantic. Now, he says, he will be able to concentrate on his first love, invention and creativity, and is looking forward to further developing and enhancing Liberty's media resources.

What do Bell Atlantic and TCI Get?

Bell Atlantic has more than 13 million telephone and cellular customers in the mid-Atlantic region. Bell Atlantic is very strong in networking but doesn't have high-capacity circuits to consumer's homes.

TCI owns 1,200 cable systems in 48 states serving more than 13 million subscribers, 10 million of which pay for premium channels such as the *Encore* movie channel (in which TCI has an equity interest). TCI also has interests in Liberty Media, the Discovery Channel, the Home Shopping Network and Turner Broadcasting. And, perhaps most importantly, TCI has high-capacity coaxial connections to its customer's homes.

Together, TCI and Bell Atlantic will have more than 22 million customers in 59 of the top 100 U.S. markets, including San Francisco, Los Angeles, Chicago, Dallas and New York. TCI's high-capacity coax can connect Atlantic Bell's 18 million miles of telephone lines directly to consumer homes, while Liberty Mutual's programming resources can provide access to a broad range of video alternatives.

Competitively, a merged Bell Atlantic/TCI would vie directly with other telephone companies for local service—a significant challenge to Nynex, Ameritech, Pacific Telesis, U S West, Southwestern Bell and BellSouth. Proponents believe such competition will drive down the cost of both long-distance and local calls.

Technically, the two companies' strengths complement each other, and offer the obvious possibility of both transforming Bell Atlantic's network into a huge video delivery system, and enhancing TCI's cable systems for voice telephone service. Future possibilities would include video-on-demand, enhanced home computer applications (such as multi-media), "smart" program guides that can learn what a family likes to watch, telephone calls on cable systems and television programming offered on telephone lines. And these possibilities are only the tip of the iceberg, since Mr. Malone reportedly has been given free rein to explore new technology and enter into new business ventures.

Pros and Cons

If this new venture sounds too good to be true—it's not! Other RBOCs have been taking tentative steps in this direction for the last few years. The convergence and compatibility of cable and telephone systems has been obvious for some time, and most of the major players in the telecommunications industry have recognized this and taken steps or developed strategies to expand their activities into other communications areas, through alliances, acquisitions or mergers.

The primary uncertainty has been the reactions of federal, state and local regulatory agencies to these steps to expand telecommunications market presence. At issue is whether mergers between cable system operators and telephone companies increase competition or create super-monopolies. Proponents of such mergers argue that a combined Bell Atlantic/TCI can now compete with other RBOCs in their own market areas, thereby offering consumers a service alternative and increasing competition. The end result, they claim, should be lower prices to the end-user.

Opponents of mergers feel that the big are simply getting bigger, and that when two monopolies are merged, you now have a super-monopoly—an entity not necessarily motivated towards increased competition or lower prices.

Regulatory Judgment

As the deal currently stands, Bell Atlantic will require court waivers allowing the TCI merger, because the terms of the 1982 breakup of the Bell System prohibited the RBOCs from providing long-distance service. TCI's satellite distribution system for its programming is considered to be a long-distance service under the 1982 ruling.

Congress has also prohibited telephone companies from offering cable service in their operating areas. In hopes of easing regulatory concerns, Ray Smith doesn't plan to challenge this ban, and has indicated that he will sell the TCI holdings located in the Bell Atlantic service area. Bell Atlantic has already won a case allowing it to offer video programming in its service area (the judgment is now under appeal), but Mr. Smith seems to not want to press his luck with the Bell Atlantic/TCI deal. Divesting the TCI holdings in Bell Atlantic's market area would remove a possible obstacle to approval of the merger.

Inevitably, the final decision will rest with Congress and the regulatory agencies. Congress will certainly have to consider whether the communications laws enacted years ago now apply to new technology and an expanded domestic and global telecommunications environment. Because the Bell Atlantic/TCI merger offers a prototypical component of a nationwide communications resource, Congress will also be forced to take an unambiguous stand on the Clinton administration's proposed *electronic superhighway*, a concept that already has strong industry support.

James H. Quello, acting chairman of the FCC, stated that he did not want to prejudge the merger, but that it could speed the implementation of the *electronic superhighway.* Vice President Al Gore has stated that "the administration supports any development in the communications marketplace that is procompetitive and fosters the development of an open, interactive information infrastructure."

Senator Howard M. Metzenbaum (D-Ohio), chairman of the Senate Judiciary subcommittee on antitrust issues, sees the merger as creating a "mega-monster" that would result in higher cable and television rates.

As is often said in legal matters, "the jury is still out" on the merger, but many industry experts feel it will take place after the obligatory review process is completed, and everyone has had their say. The review process could take as long as two years, but even if it takes longer the merger may still occur since the agreement between Bell Atlantic and TCI allows an eight-year window for the two sides to consummate the deal.

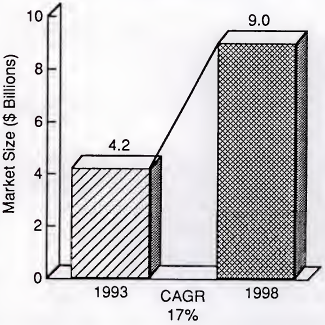
Who Gains? Who Loses?

INPUT monitors the telecommunications industry as an integral part of the market for information services. As shown in Exhibit 1, INPUT's forecast for the industry's expenditures for information services indicates a strong 17% compound annual growth rate (CAGR), from more than $4 billion in 1993 to almost $9 billion in 1998. This growth reflects

both the fundamental health of this industry and also its ability to consume information services offerings such as applications software products, professional (consulting) services, systems integration services, processing services, network services and four other categories of services provided by vendors outside of a business' IT function.

Exhibit 1

Telecommunications Sector U.S. Information Services Market 1993-1998



As noted in the first section of this bulletin, INPUT feels there has been a growing trend in the communications industry towards establishing new relationships that increase service options, expand markets, and improve competitive positioning. Many of these alliances, acquisitions or mergers have occurred without significant note or comment. And others, like the Bell Atlantic/TCI merger, attract nationwide attention, comment and analysis, and occasionally criticism.

Cable companies and telephone services providers have been traditional rivals—each jealously guarding the market which Congress, the FCC and the courts have defined to be theirs. When intrusion took place, the courtroom, not the boardroom, was the venue in which judgment was rendered and deals blessed or killed. This is still true today, but probably not for much longer, as regulations are updated to more accurately reflect the current telecommunications environment.

Technology is opening too many paths of intersection for communications companies to remain isolated by function or even geography. If the Clinton dream of a nationwide *electronic superhighway* is to become a practical reality, many of the artificial constraints on both competition and regulation are going to have to be revised to reflect current realities—not removed completely, but updated to allow one of America's great strengths, its voice and data communications resources, to continue to flourish.

As both business and consumer demands for greater access to communications resources increase, regulatory agencies at all levels will be forced to bring rulings up-to-date. Logical mergers, such as Bell Atlantic/TCI, will certainly be subject to antitrust scrutiny, but not unduly delayed or denied by outdated regulation. (TCI, as a matter of interest, has been the repeated target of antitrust review, and has in the past, successfully met each challenge.)

Such a return to business, legislative and technological reality (or currency) will be good for almost everyone. Consumers and businesses will have access to a broader range of services from alternative sources—an environment that has historically fostered both innovation and reduced costs.

Telecommunications service providers will have more freedom to compete to the extent their products, markets, prices and strategies allow.

Businesses that need telecommunications services will have more options, and the

network services providers to those businesses will be able to offer a wider range of products.

Ultimately, the providers of information services (including network services) will have an expanded market in which to sell their products.

The New Telecommunications Paradigm?

When the smoke has cleared and the deal is done, the Bell Atlantic/TCI merger may be regarded as the event that created a new telecommunications paradigm—a broad-based telecommunications conglomerate competing in as many markets as its products will permit, and considerably less hampered by outdated regulations.

If there were only one such megamonopoly, it would seem that we have returned to the days when AT&T (and the Bell System) was the only significant option for nationwide service and interconnectivity. But each of the RBOCs, along with MCI and other companies, all benefit from reduced controls, and are freer to compete with Bell Atlantic to the extent their abilities allow. Thus the new paradigm defines not just a company, but the telecommunications service provider's business structure and market strategy that are most likely to succeed in the 1990s and beyond.

This Research Bulletin is issued as part of INPUT's Information Services Market Analysis Program.
If you have questions or comments on this bulletin, please call your local INPUT organization or
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